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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1523

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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Transcontinental Gas Pipe Line Corporation (Transco) respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the District of Columbia Circuit entered in this proceeding on June 20, 1979.

OPINIONS AND ORDERS BELOW

The opinion of the court of appeals is reported at 606 F.2d 1094 (D.C. Cir. 1979) and appears in Appendix A, at pp. 1a-72a.[1] Its orders (1) denying rehear-

[1] The decision below relates principally to an issue not before the Court in this case. The pertinent portions of the decision below appear in Appendix A, at pp. 60a-62a.

ing and (2) denying suggestion for rehearing *en banc*, entered on October 31, 1979, are not reported and appear in Appendix B, at pp. 73a-76a.

The following orders of the Federal Power Commission [2] are not reported and appear at Appendices C and D, at pp. 77a-118a and 119a-130a, respectively: (1) "Opinion and Order Affirming In Part And Reversing Initial Decision on Reserved Issues and Establishing Just and Reasonable Pipeline Rates," Opinion No. 801, issued May 31, 1977, and (2) "Opinion and Order Denying Rehearing In Most Respects of Opinion and Order Establishing Just and Reasonable Pipeline Rates," Opinion No. 801-A, issued July 29, 1977.

JURISDICTION

The judgment of the United States Court of Appeals for the District of Columbia Circuit was entered on June 20, 1979. A timely petition for rehearing and a suggestion for rehearing *en banc* were denied on October 31, 1979. At the request of Petitioner, this Court, by order of January 17, 1980, extended the date for filing the instant Petition to and including March 29, 1980. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

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[2] On October 1, 1977, pursuant to Section 402 of the Department of Energy Organization Act, Pub. L. No. 95-91, § 402, 91 Stat. 583 (1977) and Executive Order No. 12,009, 3 C.F.R. 142 (1978) the Federal Power Commission (FPC) ceased to exist and its functions and regulatory responsibilities were transferred to the Federal Energy Regulatory Commission (FERC). As used in this petition, the term "Commission" refers to either the FPC or the FERC as the context requires.

QUESTION PRESENTED

Whether the Commission, in setting rates under the prudent investment standard of ratemaking under Section 4 of the Natural Gas Act, may deprive a natural gas pipeline of the opportunity to recover from its customers costs prudently expended on unsuccessful gas supply projects undertaken for the benefit of those customers.

STATUTORY PROVISIONS INVOLVED

Sections 4(a) and 4(e) of the Natural Gas Act, 15 U.S.C. §§ 717c(a) and (e), are set forth in Appendix E, at pp. 131a-132a.

STATEMENT OF THE CASE

Transco is one of the major interstate natural gas pipeline systems in the United States and is subject to regulation by the Commission under the Natural Gas Act. Transco owns and operates extensive pipeline facilities which are utilized to transport gas from its supply area in the Gulf Coast onshore and offshore areas to markets located primarily in the mid-Atlantic region from Atlanta, Georgia, to New York City.

The proceeding from which the instant issue arose involved a general rate increase filed by Transco in July, 1974 pursuant to Section 4(e) of the Natural Gas Act. Insofar as pertinent here, among the capital expenditures reflected by Transco in its filed rates was an amount of $12,448,692 [3] representing preliminary

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[3] The court below referred to four projects with a total cost of $22,309,402 being at issue; however, prior to the Commission's decision, Transco had eliminated from its proposed rate increase $9,860,710 of expenditures related to a proposed synthetic gas plant which had been revived.

expenditures made by Transco on three supplemental gas supply projects involving the gasification of various hydrocarbon feedstocks designed to produce pipeline quality synthetic gas in commercial quantities. These projects were undertaken in an effort to alleviate the shortage of gas on Transco's system which had developed in the early 1970's due to a national shortage of domestic natural gas supplies available to interstate markets and which had required Transco to curtail gas deliveries to its customers commencing in 1971. However, after the 1973-1974 Arab oil embargo, the necessary long-term commitments for feedstocks became unattainable on a basis which would permit the projects to go forward and, consequently, the projects were abandoned.

Ultimately, most of the issues in the general rate case were resolved through the settlement process, but the propriety of Transco's recovery of the costs of the unsuccessful projects was reserved for separate hearing and decision. During trial and in briefs to the administrative law judge and later the Commission, it was Transco's consistent position that the traditional test of prudency should be the basis for determining whether to allow or disallow the cost recovery of the failed projects. At no time during the proceedings did any party question Transco's evidence or contentions concerning the prudence of its expenditures. However, numerous different theories were espoused at various stages of the case by the Commission's staff, the administrative law judge and the Commission itself, all leading to the same result of cost disallowance for the projects. Despite these varying theories, it was not until the last step in the administrative process, the order denying rehearing, that the Commission seized

upon the "used and useful" concept as its basis for disallowance. App. D, pp. 121a-122a.

Transco appealed the Commission's opinions to the court below. In addition to reiterating the appropriateness of the prudent investment standard and citing the Commission's inconsistent precedents which had uniformly permitted natural gas pipelines to recoup the costs of unsuccessful efforts to develop storage fields,[4] Transco also pointed out that the Commission's refusal to allow cost recovery in this case was totally at odds with a contemporaneous electric utility rate decision where the company was allowed to recover the costs of a failed power supply project. *See Southern California Edison Co.* (Opinion No. 821), —— FPC ——, [1977] 13 FED. POWER SERV. (M-B) 5-163, 5-171.

The court below, erroneously characterizing the issue raised by Transco concerning cost recovery of failed projects as "subsidiary" and addressing the matter in an extremely cursory fashion, affirmed the Commission. Without any attempt to reconcile the result of this case with the Commission's precedents allowing cost recovery for abandoned gas and electric projects, and without any attempt to reconcile its own inconsistent precedent in *Washington Gas Light Co.* v. *Baker,* 188 F.2d 11, 19 (D.C. Cir. 1950), the court summarily concluded that "for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be 'used and useful' in providing service." App. A, p. 62a.

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[4] *E.g., Midwestern Gas Transmission Co.,* 32 F.P.C. 993 (1964); *Southern Natural Gas Co.,* 29 F.P.C. 323 (1963).

Transco filed a timely petition for rehearing with the court below, along with a suggestion for rehearing *en banc*. Transco also lodged with the court two additional contemporaneous decisions of the Commission in electric rate cases where the recovery of costs expended on failed projects was specifically allowed. *See New England Power Co.* (Opinion No. 49), —— FERC ——, [1979] 18 FED. POWER SERV. (M-B) 5-484, 5-510; *Southern California Edison Co.* (Opinion No. 62), —— FERC ——, [1979] 18 FED. POWER SERV. (M-B) 5-980, 5-985 to 5-986. Although the court requested and received a response from the Commission to Transco's petition for rehearing, on October 31, 1979, the court denied rehearing and the suggestion for rehearing *en banc* without comment. App. B, pp. 207a-210a.

REASONS FOR GRANTING THE WRIT

1. The Resolution Of The Question Presented In This Case Will Determine Whether The Gas Pipeline Industry Will Be Able To Initiate Supplemental Gas Supply Projects To Maintain Service To Gas Consumers

In the years immediately after World War II, the natural gas industry began to experience a period of explosive growth, with pipelines being constructed into virtually every sector of the lower forty-eight states. This expansion, aided by extremely low wellhead prices for gas which previously had been principally a by-product of oil production and had largely been flared into the atmosphere, continued unabated into the late 1960's, at which point natural gas supplied about one-third of the energy needs of the country.

Commencing in 1970, shortages of natural gas began to appear in the interstate markets and curtailments

of service began to be felt in scattered areas of the country. These curtailments continued and increased throughout the early and mid-1970's until, in combination with a severely cold winter east of the Rocky Mountains, the majority of the country suffered a natural gas emergency condition in the 1976-1977 winter, resulting in numerous plant and school closings and significant discomfort to large segments of the populace.[5]

During the halcyon days of the 1950's and 1960's, the gas industry was almost entirely dependent upon domestic natural gas producers for their supplies. In the face of prospects in the early 1970's for increasing shortages of domestic supplies, pipelines such as Transco began to look for means of alleviating these shortages through institution of non-conventional supply sources such as import projects and various potential gasification processes from coal and liquid petroleum feedstocks.

In Transco's case, it explored numerous supplemental supply projects including the importation of liquefied natural gas (LNG) from overseas sources, importation of Canadian and Mexican gas, and the manufacture of high-Btu synthetic gas (SNG) from various hydrocarbon feedstocks. Many of these projects such as the three gasification projects at issue in this pro-

[5] In the last two years, deliverable gas supplies have improved due to a number of factors, including increased domestic well drilling and passage of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301 *et seq.*, which afforded parity of access by interstate pipelines to intrastate sources of gas supply. It should be noted, however, that, since the national shortage of gas first appeared, the country has consistently used more gas than has been found, so that known reserves of gas in the lower 48 states are decidedly less today than they were in 1970.

ceeding were high risk ventures totally unlike the conventional underground pipelines built to carry gas supplies from wellhead to market which had been the principal function of pipeline companies prior to the onset of the national shortage. Nevertheless, although pipelines' rates were regulated by the Federal Power Commission on a strict prudent investment cost basis which would preclude the potentially large unregulated rewards of successful high risk ventures, pipelines embarked on numerous of these high risk ventures in full expectation—based upon their understanding of the prudent investment standard of ratemaking theretofore consistently applied—that prudent expenditures would be recovered whether or not the projects proved to be successful. The Commission's decision in this case, however, proved those expectations to be illusory.

The narrow question in this case, whether pipelines which are regulated on the prudent investment method of ratemaking can be required to absorb the cost of their prudent but unsuccessful projects, is important far beyond the immediate impact upon Transco or even the other pipelines whose rate treatment in this area may be dependent upon the outcome of this case. The true significance of this case lies in its impact upon the future conduct of pipelines in entering into high risk ventures in efforts to maintain service to their customers in the face of the shortage of conventional natural gas supplies. If the Commission's decision is upheld, venture capital will simply not be forthcoming to assume the high risks of loss for project failure in view of the meager reward of a low risk utility return on invested capital if the projects prove

to be successful. This means ultimately that supplemental energy projects will be undertaken, if at all, by (1) unregulated enterprises whose risks and rewards are dictated by the free market place, (2) electric utilities and other regulated enterprises whose investments are in fact protected against project failure by the regulators (see pp. 13-14, *infra*) or (3) the federal government. In any event, the question presented has great significance for the future role of the gas pipeline industry in development of supplemental energy sources for the country and, therefore, it is a question which should be resolved by this Court.

2. The Commission's Claimed Authority To Disallow Recovery Of Pipelines' Prudent Expenditures Raises Important Questions Of Confiscation And Proper Administration Of Federal Regulatory Statutes

In this Section, we will show that the Commission is arbitrarily and capriciously reaching diametrically opposite results with respect to cost recovery of unsuccessful projects by gas and electric companies under its jurisdiction. Under the circumstances, it is submitted that this Court should establish the rule of law which will be applied by regulatory agencies in a consistent fashion, and which can be relied upon by utilities and the financial community in their investment decisions. Otherwise, regulatory agencies such as the Commission will be free to permit or deny cost recovery on the basis of whichever result suits its whim at the moment. Moreover, we will show that to the extent that gas pipelines are not allowed to recover the costs of their prudent expenditures, the in-

evitable result is confiscation in violation of the due process clause of the Constitution.[6]

In the instant case, the Commission in the first instance and the court in its cursory affirmance seemed to assume, without any meaningful discussion of the precedents or rationale, that the "used and useful" concept was a part of the traditional test for cost recovery.[7] To the contrary, we submit that the cases demonstrate that the used and useful concept is inconsistent with the Commission's prudent investment standard for cost recovery, and when the concepts are applied as a dual test, confiscation of property devoted to public service results.

Since its prerogative to do so was confirmed in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Commission has consistently employed the prudent investment theory of ratemaking based on original

[6] In another case involving efforts to augment dwindling gas supplies, *Public Service Commission of New York* v. *F.P.C.*, 467 F.2d 361, 370 (D.C. Cir. 1972), another panel of the court below aptly summarized the confiscation issue as follows:

> [U]ltimately the consumers must be ready to shoulder the costs of such operations, if they are necessary to supply them with power. This is so because *under the due process clause of the Constitution no public utility could be compelled to absorb its own costs and not pass them on to the consumers.* (Emphasis supplied.)

[7] In a footnote, the court below cited as its only authority *Tennessee Gas Pipeline Co.*, 48 FPC 149 (1972) *aff'd, Tennessee Gas Pipeline Co.* v. *F.P.C.*, 487 F.2d 1189 (1973); that case, however, has nothing to do with the used and useful concept.

cost.[8] In the agency proceeding in the *Hope* case, the Commission explained that *investment* itself was the critical distinction between the prudent investment and fair value methodologies:

> With the decline in favor of 'fair value' as the only mode of public utility rate regulation, its keystone, reproduction cost, crumbles. *Bona fide investment figures now become all important in the regulation of rates.*

Hope Natural Gas Co., 3 FPC 150, 164 (1942) (emphasis supplied). Thus, whether a *bona fide* investment becomes used and useful is immaterial to cost recovery under the Commission's chosen methodology.[9]

The prudent investment standard for utility ratemaking is grounded on original cost; it differs from the fair value (or reproduction cost new) theory of rate

[8] Justice Brandeis explained the prudent investment theory, and its consequences, as follows:

> *The thing devoted by the investor* to the public use is not specific property, tangible and intangible, but *capital embarked in the enterprise. Upon the capital so invested the federal Constitution guarantees to the utility the opportunity to earn a fair return.* (Emphasis supplied.)

Missouri ex rel. *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 290 (1923) (concurring opinion).

[9] It is not suggested that the used and useful concept has no significance in the regulatory scheme under the Natural Gas Act. The Commission typically employs the used and useful test to distinguish between plant in service and construction work in progress (CWIP), the latter being capitalized and included in rate base only upon completion of construction. The phrase also has relevance in connection with establishment of depreciation rates whose purpose is recovery of plant investment over the useful life of the property.

base valuation in that it establishes rates on the basis of the actual (*i.e.*, original) costs incurred by the utility, whereas the fair value method is premised on an estimate of the current value of utility property which, because of factors such as appreciation in value due to inflation, may far exceed actual original cost.

This basic difference in the rate base valuation theories of original cost (prudent investment) versus reproduction cost new (fair value) leads to different consequences where expenditures are excluded from rate base under the two methods. Exclusion of abandoned or unsuccessful projects from rate base under the fair value method does not mean that the utility will not be allowed a fair return, because unlike the result reached under the original cost method, the utility's remaining plant investment may receive a current valuation much higher than original cost due to inflation. In other words, the effect of rate base exclusion can be offset by a finding of fair value sufficient to avoid a confiscatory result.[10] By way of contrast, such is *not* the case where the prudent investment (original cost) method is utilized, since there is no latitude in a

[10] And, under the fair value (reproduction cost new) test, there is no reason that property not used or useful should be included in rate base, as explained by this Court in *Los Angeles Gas Co.* v. *Railroad Commission of California*, 289 U.S. 287, 311 (1932):

> Whatever may be said of the propriety of including this entire [abandoned manufactured] gas plant in valuation based on historical costs, in the light of prudent investment, we perceive no reason for embracing unnecessary facilities in an estimate of cost of reproduction.

It is also understandable that the origin of the used and useful concept can be traced to the fair value method rather than to the prudent investment theory. In *Smyth* v. *Ames*, 169 U.S. 466 (1898), this Court made the "fair value of the property being *used* by [the utility] for the convenience of the public" its basis for determining reasonableness of rates. *Id.* at 546 (emphasis supplied).

valuation based on actual costs. Therefore, rate base exclusion of prudent expenditures under the original cost methodology *will result in confiscatory rates* unless the utility's rate of return has taken into account the inevitability that some high risk ventures such as those involved in this case will fail. *See Washington Gas Light Co.* v. *Baker*, 188 F.2d at 19-20. In that regard, however, the Commission can point to no instance where, in setting pipeline rates of return, it has given consideration to this entirely new dimension of potential capital losses due to the high risk nature of supplemental gas projects.

In stark contrast to the Commission's disallowance of gas pipelines' prudent expenditures for failed projects designed to offset declining gas supplies, electric utilities are permitted by the same Commission to this very day to recover expenditures on power supply projects that are abandoned. *See Southern California Edison Co.* (Opinion No. 62), —— FERC ——, [1979] 18 FED. POWER SERV. 5-980; *New England Power Co.* (Opinion No. 49), —— FERC ——, [1979] 18 FED. POWER SERV. 5-484; and *Southern California Edison Co.* (Opinion No. 821), —— FPC ——, [1977] 13 FED. POWER SERV. 5-163. The favorable treatment of electric utilities' prudent expenditures in failed projects is entirely proper, for the reasons discussed above. However, since the pertinent provisions of the Federal Power Act and the Natural Gas Act under which rates are regulated are virtually identical,[11] there can be no justification for the diametrically opposite treatment which the Commission affords the two classes of public utilities subject to its jurisdiction in connection with

[11] *See F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348, 350-351 (1956).

expenditures on unsuccessful projects. The Commission made no effort to explain or reconcile this inconsistent treatment and, we submit, there is no basis for different ground rules and results for the two industries which are in competition for energy markets. Such actions are neither rational nor defensible.

Although this Court's decision in *Hope, supra,* 320 U.S. at 602, does not bind the Commission to any particular theory of rate base valuation, it is submitted that the theory chosen by the agency must be applied consistently and must result in an opportunity to recover costs, including a reasonable return on investment. However, unless this Court accepts this case and provides the necessary guidance to regulatory agencies, they will be free to adopt whichever result suits the particular whim of the moment.

Because of the important question of confiscation under the due process clause of the Constitution, and the proper administration of the federal regulatory statutes administered by the respondent Commission, this Court should resolve the question presented.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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